CC:P&SI-TR-45-1568-90
Br8:BWeberman

Acting District Director
North Dakota District

Assistant Chief Counsel
Passthroughs & Special Industries CC:P&SI:8

Technical Assistance Request on Sections 4401 and 4402 of the Internal revenue Code Initiated by Revenue Agent David Nilles

This is in reply to your request for technical assistance with respect to the application of the wagering excise taxes to certain wagering operations conducted by non-profit organizations. You have also asked about the application of the tax on unrelated business income contained in section 511 of the Code to certain wagers.

ISSUE 1

Facts

North Dakota law permits the sales of charitable gaming tickets (CGTs). Although the methods of sale and play vary, the following is typical.

Under one method of sale and play, pull tabs are sold to purchasers. Pull tabs may be sold by either a human vendor, or by a dispensing machine. The dispensing machine merely dispenses pre-printed pull tabs. The purchaser then breaks open the pull tab to find a number or symbol. Certain numbers or symbols have been pre-designated as winning combinations, and prize winners are paid awards. The amount of the award may exceed the cost of the pull tab.

Issue

Are pull tab dispensing machines coin-operated gaming devices exempt from the wagering tax by reason of section 4402(2) of the Code?

Conclusion

Yes.

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Discussion

Section 4401 of the Code imposes an excise tax on certain wagers. Section 4402(2) provides that any wager placed in a coin-operated device as defined in section 4462 of the Code as in effect for years beginning before July 1, 1980, or on any amount paid, in lieu of inserting a coin, token, or similar object, to operate a device described in section 4462(a)(2) as so in effect is exempt from the tax on wagers. To determine whether the section 4402(2) exemption applies it is necessary to look at the law and Service positions as then in effect.

Rev. Rul. 71-487, 1971-2 C.B. 376, specifically holds that a vending machine is a coin-operated gaming device if the machine dispenses tickets that will put in motion a process by which it will be immediately determined whether the player will win a cash prize. The vending machine at issue in that ruling dispensed nothing other than a printed lottery ticket. See also Rev. Rul. 67-124, 1967-1 C.B. 307; Rev. Rul. 62-135, 1962-2 C.B. 282. We are of the opinion that these rulings control characterization of the pull tab dispensing machines described in your request as coin-operated gaming devices.

You state several reasons in support of the position that the dispensing devices are not within the definition of coin-operated gaming devices. First, you state that some of the machines accept bills but not coins. However, under former section 4462(a)(1) of the Code, a coin-operated gaming device may accept a "coin, token, or similar object." Paper money fits within the definition as a similar object.

Second, you note that at some sites customers may purchase pull tabs from either a human vendor or a dispensing machine. You state that the incidence of taxation should not turn on the manner of sale. The distinction drawn by Congress in exempting certain wagers from tax depending on whether they are placed with a person or a mechanical device may seem arbitrary. However, the distinction is explicitly provided for by statute, which plainly provides for exemption based upon the use of a "coin-operated device."

Third, you point out that the machines in question merely dispense pre-printed tickets, and that each "deal" has a pre-set number of winners. You indicate that you believe that a distinction can be made between machines that are essentially passive, that is, merely dispense a ticket that has been pre-determined as a winner or a loser, and those machines in which the operation of the machine includes an element of play so that

whether the player wins is determined during play. You state that the dispensing machines do nothing different than human sellers. Accordingly, you indicate that these machines are not games of chance, but merely aids in the conduct of the game. However, machines described in the rulings cited above do not have an element of "play" in them. Moreover, the holdings in the above-cited rulings involved machines whose function was limited to dispensing tickets.[1]/ Accordingly, the Service position is that such an element is not a factor in characterizing a machine as a coin-operated gaming device.

ISSUE 2

Facts

Situation 1. An organization that is exempt from tax under section 501 (such as, but not limited to organizations described in sections 501 (c) (4), (7), (8), (9), (10), and (19)), sells CGTs like those described in the factual situation described in Situation 1 in transactions that would otherwise be taxable under section 4401, at a facility that the organization owns or leases, to its members and their bona fide guests.

Situation 2. Same as Situation 1, but the organization also has an area open to the public, such as a bar, where non-members are allowed to enter and purchase CGTs. The areas in which members and non-members can purchase CGTs are segregated.

Situation 3. Same as Situation 1, but the organization also sells CGTs to the public at a site open to the public.

Issue

Is the tax imposed by section 4401 imposed on the sale of CGTs sold by the organization?

Conclusion

Situation 1: No.

Situation 2: If the organization segregates the drawings in which members and their bona fide guests participate from those

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[1]/ We are aware that the Service's position as stated above has not been universally accepted by the courts, some of whom would hold that dispensing machines are not coin-operated gaming devices. See, e.g., Harvey v. United States, 214 F. Supp. 80 (D. Ore. 1962) and the discussion contained in G.C.M. 36023 (Oct. 1, 1974) at 8-10.

in which the public may participate, the tax will generally not be imposed on the sales in drawings in which only members and their bona fide guests may participate. However, depending on the facts, the drawings in which the public participates may be subject to imposition of the tax.

Situation 3: The tax may be imposed on the sale of CGTs in drawings open to the public depending on the facts.

Discussion

Initially, the pull tab operation described by you is generally considered a lottery. See Rev. Rul. 57-258, 1957-1 C.B. 418. However, the conduct of such an operation by an organization exempt from income tax under section 501 is exempt from the definition of lottery under section 4421(2)(B) if no part of the net proceeds derived from the drawing inures to the benefit of any private shareholder or individual. The exemption provided in section 4421(2)(B) does not apply if any part of the proceeds inures to the benefit of any private individual. See section 44.4421-1 (b)(ii) and (c) of the Wagering Tax Regulations; Rev. Rul. 74-425, 1974-2 C.B. 373. Absent unusual circumstances, such as when employees working on the activity are overpaid, no inurement will be found when the proceeds of a drawing are derived solely from tickets purchases by members and their bona fide guests. The rationale for finding no private inurement when participation in a drawing is limited to members and bona fide guests is that the profits of the operation are similar to the receipt of dues by the organization from its membership. See Rev. Rul. 74-425. Accordingly, a drawing described in Situation 1 and (2) that is limited to members and their bona fide guests would ordinarily be exempt from the wagering tax imposed by section 4401.

When sale of CGTs in a drawing is made either solely or in part to members of the public some private benefit may inure.[2]/ The question of when the proceeds of a drawing inure to the benefit of a private individual is a question of fact. Whether private benefit inures depends on such factors as the use to which the proceeds are dedicated, and whether the organization is exempt under section 501(c)(3) or another subsection (see, e.g., the discussion in LTR 8806001 (May 19, 1987)). Frequently, the

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[2]/ Section 4421(2)(B) focuses on the net proceeds derived from a "drawing." Thus, if the purchase of some tickets by members of the public causes a drawing to be defined as a lottery not only the tickets purchased by the public, but the entire drawing, will be treated as a lottery.

revenue generated by sales to the public will be considered to inure to the benefit of the organization's members, and will thus give rise to treatment of the drawing as a lottery. We have attached for your convenience LTR 8722003 (February 3, 1987), a National Office Technical Advice Memorandum. It contains a detailed discussion of the law in this area and applies the law to circumstances similar to those described by you.

ISSUE 3

Facts

Same as in Issue 1.

Issue

If the charitable gaming ticket dispensing machines are found to be coin-operated gaming devices within the meaning of section 4402(2) of the Code, would the exceptions to unrelated business income provided by P.L. 98-369, § 311 and/or section 513(f) of the Code be applicable, or would such income be subject to the tax imposed by section 511 of the Code.

Discussion

This issue is within the jurisdiction of the Director, Exempt Organizations, rather than this office. Accordingly, we have referred your memorandum to them and asked that they send their response to us. We will forward it to you immediately upon receipt.

* * *

This response is advisory only and does not represent an expression of the views of the Service as to the application of law, regulations, and precedents to the facts of a specific case. Further, the response is not to be furnished or cited to taxpayers or representatives and is not to serve as the basis for closing a case. We have not recommended that the substance of this memorandum be published as a revenue ruling.

Acting District Director
North Dakota District

We appreciate your continuing efforts in interpreting and administering these laws.

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Attachment: LTR 8722003